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No. 66

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IN THE

Supreme Court of the United States

OCTOBER TERM 1965

LOUIS C. LERNER, individually and as doing business under the firm name and style of Lerner & Company, and as a Director of Fashion Park, Inc.,

JEROME LEWINE, EDMUND W. FITZGERALD, ARTHUR S. NEUMARK, ROBERT PARKES BARUCH, LEWIS D. RAABIN, E. MILO GREENE, STANLEY HESSE, WALTER CAMPBELL GIBSON, HENRY A. ZOELLER, ROBERT POLLACK, JEROME LEWINE, JR., ALVIN SCHONFELD, ARTHUR MORRIS, GERSON D. LUBLIN, WILLIAM P. GREEN, MORRIS HOFFENBERG, NORMA P. LEWINE, JACOB SCHONFELD, MARINA BARUCH DOYLE, LEO M. C. OLIVER, JULIAN BLASS, FLORENCE S. CLAYTON, HATTIE G. MORRIS and HELEN F. SPOONER, doing business under the firm name and style of H. Hentz & Co., a co-partnership, and WILLIAM P. GREEN, individually,

Respondents,

FASHION PARK, INC., *et al.*,

Defendants.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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PETITIONER'S REPLY MEMORANDUM

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TABLE OF CONTENTS

	PAGE
The Decision Below Is Contrary to Decisions of This Court	4
The Decision Below Conflicts With Decisions of Other Circuits	6
The Decision Below Is Contrary to Opinions of the S.E.C.	7
The Decision Below Is Contrary to the Intent of Congress	8
The Decision Below Is Contrary to the Views of Commentators on the Subject	9
The Decision Below Conflicts With Other Holdings of the Second Circuit Itself	10

CASES CITED

Archer v. Securities & Exchange Comm'n, 133 F. 2d 795 (C. A. 8th Cir.), cert. denied, 319 U. S. 767	6
Arleen Hughes v. Securities & Exchange Comm'n, 174 Fed. 2d 969 (C.A.D.C. Cir.)	6
Charles Hughes & Co. v. Securities & Exchange Comm'n 139 F. 2d 434, cert. denied, 321 U. S. 786	10
In the Matter of Cady, Roberts & Co., 40 S.E.C. 907 (1961)	7
In the Matter of Ward La France, 13 S.E.C. 373, 380, 381 (1943)	8

PAGE

J. I. Case Co. v. Borak, 377 U. S. 426 (1964) 8

Kardon v. National Gypsum Co., 73 Fed. Supp. 798 (E. D. Pa. 1947) 7

Mosser v. Darrow, 341 U. S. 267, 271, 95 L. Ed. 927, 932, 71 S. Ct. 680 5

N. Sims Organ Co. v. The Securities and Exchange Commission, 293 Fed. 2d 78 10

Norris & Hirshberg v. Securities & Exchange Comm'n, 177 F. 2d 228 (C.A.D.C. Cir.) 7

S.E.C. v. Capital Gains Research Bureau, 375 U. S. 180 .....2, 3, 4, 6, 7, 9

Speed v. Transamerica Corp., 235 F. 2d 369 (C. A. 3d Cir.) 7

Strong v. Repide, 213 U. S. 419 6

STATUTES CITED

Investment Advisers Act of 1940 .....4, 6, 8

Securities Exchange Act,

Section 17(a) 7

Section 10(b) 1, 7, 9

Rule 10b5 7

Section 15(c)(1) 9

Securities Act of 1933 8

Trust Indenture Act of 1939 8

PAGE

MISCELLANEOUS

H. R. Rep. No. 85, 73rd Cong. 1st Sess. 8

Shulman, Civil Liability and the Securities Act, 43 Yale L. J. 227 8

Report of Special Study of Securities Markets of the Securities and Exchange Commission, H. R. Doc. No. 95, 88th Cong., 1st Sess. (1963) 8

Loss, Securities Regulation at pages 1438, 1439, 1452, 1702 9

Fleischer, Federal Corporation Law 9

Knauss, A Reappraisal of the Rule of Disclosures, 62 Mich. Law Review, 607, 614 (1964) 9

78 Harv. Law Rev. 9

IN THE

Supreme Court of the United States

OCTOBER TERM 1964

No. 1027

LOUIS C. LERNER, individually and as doing business under the firm name and style of Lerner & Company, and as a Director of Fashion Park, Inc.,

JEROME LEWINE, EDMUND W. FITZGERALD, ARTHUR S. NEUMARK, ROBERT PARKES BARUCH, LEWIS D. RAABIN, E. MILO GREENE, STANLEY HESSE, WALTER CAMPBELL GIBSON, HENRY A. ZOELLER, ROBERT POLLACK, JEROME LEWINE, JR., ALVIN SCHONFELD, ARTHUR MORRIS, GERSON D. LUBLIN, WILLIAM P. GREEN, MORRIS HOFFENBERG, NORMA P. LEWINE, JACOB SCHONFELD, MARINA BARUCH DOYLE, LEO M. C. OLIVER, JULIAN BLASS, FLORENCE S. CLAYTON, HATTIE G. MORRIS and HELEN F. SPOONER, doing business under the firm name and style of H. Hentz & Co., a co-partnership, and WILLIAM P. GREEN, individually,

Respondents,

FASHION PARK, INC., *et al.*,

Defendants.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

---

PETITIONER'S REPLY MEMORANDUM

Petitioner sued under Section 10(b) of the Securities Exchange Act to recover from a director-insider profits realized by him on a resale of stock shortly after his purchase from plaintiff. Petitioner relied below on the non-

disclosure by the director (1) of his insider capacity and (2) of the fact that an important change had occurred in the corporate business affecting the value of the stock. The courts below interpreted the Act to require proof not only of "non-disclosure" of a material fact but also "reliance" by the plaintiff and dismissed the complaint, saying:

> "Disagreement centers on the applicability and meaning of the requirement that *reliance* be placed upon the misrepresentation. Our examination of the authorities satisfies us that this requirement also is carried over into civil suits under Rule 10b-5." (Opinion below, p. 582)

Petitioner urges that review by this Court of such holding is of great importance to the investing public and the financial community. Particularly is this true in view of the prominence given in the public press recently to the action instituted by the Securities Exchange Commission against the directors of the Texas Gulf Sulphur Company. For example, the New York Times of Sunday, April 25th said of that action:

> "The commission, by its action * * * appears to be saying that a director of a company has an obligation not to act on inside news until he is sure that it has reached the public. The commission takes the view that it served notice to this effect in the Cady, Roberts case."

A similar question was deemed by this Court to be of sufficient importance for certiorari to be granted in *S.E.C.* v. *Capital Gains Research Bureau*, 375 U. S. 180. In that case the action was one described by the Court to be of an equitable or prophylactic action. This case is in the area apparently left open by *Capital Gains*, viz., the application of the rationale of that decision to a private suit at law for damages, including a determination of whether it is

desirable to apply common law "doctrines of fraud and deceit which developed around transactions involving land and other tangible items of wealth * * * to the sale of such intangibles as * * * securities * * *." (*S.E.C.* v. *Capital Gains Bureau,* at p. 194.)

This Court should settle the question of the applicability to private suits at law of the Commission's philosophy of full disclosure as upheld in *Capital Gains* and as announced to the public in the Texas Gulf Sulphur situation under the very Statute here involved. Particularly is this true in a case involving Section 10b and Rule 10b-5 which potentially have such enormous importance to a substantial segment of the financial community and the investing public. In the words of the author of the Harvard Law Review article referred to, *infra,* page 9,

> "The Court's sweeping language [in *Capital Gains*] in holding § (2) irrelevant will have as yet undetermined effects on private actions under 10b-5, where the law is already unclear as to the need for *scienter.*" (78 Harvard Law Review (p. 295 n. 29))

Petitioner also urges that certiorari should be granted because the opinion below appears to be contrary to the express intent of Congress, to conflict with the import of decisions of this Court, decisions in other circuits, published opinions of the Commission, views of commentators, and indeed, opinions of the Second Circuit itself in other cases.

For the purpose of this application the factual findings below are accepted and it is not urged, as suggested by respondents' briefs, that this Court review such factual findings. Rather, it is urged that under the admitted facts that (a) defendant Lerner was at all material times a director of Fashion Park, Inc., and (b) there was a failure to disclose the adoption of the Board resolution of November 4, 1960 to the effect that Fashion Park, Inc. must merge

or sell to survive, there exists such a violation of the anti-fraud statute as permits recovery without further proof.

The Decision Below Is Contrary to Decisions of This Court

Petitioner reads this Court's opinion in *Capital Gains* as imposing absolute liability on an insider-director to disclose any material information which the insider possesses when the insider is purchasing stock from an outside stockholder. Such disclosure should have been not merely of Lerner's identity. In this case, on the admitted facts, Lerner, the insider-director failed to disclose to List that at a meeting of Fashion Park directors held November 4, 1960, in which he himself had participated, the Directors voted to sell or merge the business of Fashion Park to correct the corporation's hopeless financial condition which Lerner said "was literally forcing the company out of business" (208a). It is submitted that a logical extension of the opinion in *Capital Gains* imposes the absolute liability for which petitioner here contends in a private suit for damages such as this as well as in equitable suits by the Commission. Even Justice Harlan, in his dissent in *Capital Gains,* acknowledged that the majority had adopted an "absolute rule of disclosure". (Justice Harlan's dissent at p. 206.)

Examination of the language of the majority opinion of Justice Goldberg in *Capital Gains* compels the conclusion that the legal philosophy he so painstakingly formulated there is neither confined in its application to equitable actions by the Commission nor to cases arising under the Investment Advisers Act of 1940. Thus, Justice Goldberg states (p. 200):

> "This, of course, is but another way of putting the rejected argument that the elements of technical common-

law fraud—particularly intent—must be established before an injunction requiring disclosure may be ordered. It is the practice itself, however, with its potential for abuse, which 'operates as a fraud or deceit' within the meaning of the Act when relevant information is suppressed.

* * * Failure to disclose material facts must be deemed fraud or deceit within its intended meaning, for, as the experience of the 1920's and 1930's amply reveals, the darkness and ignorance of commercial secrecy are the conditions upon which predatory practices best thrive. To impose upon the Securities and Exchange Commission the burden of showing deliberate dishonesty as a condition precedent to protecting investors through the prophylaxis of disclosure would effectively nullify the protective purposes of the statute. * * * The statute, in recognization of the adviser's fiduciary relationship to his clients, requires that his advice be disinterested. To insure this it empowers the courts to require disclosure of material facts. It misconceives the purpose of the statue to confine its application to 'dishonest' as opposed to 'honest' motives. As Dean Shulman said in discussing the nature of securities transactions, what is required is 'a picture not simply of the show window, but of the entire store * * * not simply truth in the statements volunteered, but disclosure.' The high standards of business morality exacted by our laws regulating the securities industry do not permit an investment adviser to trade on the market effect of his own recommendations without fully and fairly revealing his personal interests in these recommendations to his clients.

Experience has shown that disclosure in such situations, while not onerous to the adviser, is needed to preserve the climate of fair dealing which is so essential to maintain public confidence in the securities industry and to preserve the economic health of the country."

Petitioner argues here that Congress's intent was to require an equally broad remedial construction of Section 10b in actions of a similar nature against corporate insiders, so that recovery could be had for non-disclosure by that corporate insider of the material facts unimpeded by narrow technical common law requirements such as "the reliance" imposed on petitioner by the Court below. Indeed the statute here involved appears to impose a greater duty than the Investment Company Act provision in *Capital Gains.*

Petitioner argues that the Court below misapplied the provisions of the 1934 Act just as this Court said the same Court had erred in construing the Investment Advisers Act of 1940 and "by requiring proof of 'misstatements', unsound advice, bribery, or intent to unload 'worthless stock', the court read the statute, in effect, as confined by traditional common-law concepts of fraud and deceit." (*S.E.C.* v. *Capital Gains Bureau,* footnote 6.)

It would appear to be sheer sophistry to argue that petitioner should have proved his reliance on something that was not in fact disclosed to him.

In the petition for certiorari reliance was also placed on asserted conflict between the decision below and *Strong* v. *Repide,* 213 U. S. 419. Respondents challenge the asserted conflict in their briefs in opposition. Petitioner urges the continued vitality of *Strong* v. *Repide* and its applicability in this case.

The Decision Below Conflicts With Decisions of Other Circuits

Petitioner urges that the decision below conflicts with the decisions in other circuits such as *Archer* v. *Securities & Exchange Comm'n,* 133 F. 2d 795 (C. A. 8th Cir.), cert. denied, 319 U. S. 767; *Arleen Hughes* v. *Securities & Ex-*

change Comm'n, 174 Fed. 2d 969 (C.A.D.C. Cir.); *Norris & Hirshberg* v. *Securities & Exchange Comm'n*, 177 F. 2d 228 (C.A.D.C. Cir.); *Speed* v. *Transamerica Corp.*, 235 F. 2d 369 (C. A. 3d Cir.); *Kardon* v. *National Gypsum Co.*, 73 Fed. Supp. 798 (E. D. Pa. 1947).

Respondents' briefs in opposition disputed this asserted conflict. That there is such a conflict, however, is apparent from the citation of the foregoing cases (except for the *Kardon* case) by Justice Goldberg in footnote 52 of his opinion in *Capital Gains* and by the fact that Justice Harlan in his dissent undertook to distinguish the cases, thereby recognizing that they form one of the pillars upon which the majority opinion in *Capital Gains* rested, even though he, as distingiushed from the majority, concluded that they were not applicable.

The Decision Below Is Contrary to Opinions of the S.E.C.

The Commission, in its opinion *In the Matter of Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), said (pp. 910-911):

> "* * * The purchase and sale of securities is a field in special need of regulation for the protection of investors. To this end one of the major purposes of the Securities acts is the prevention of fraud, manipulation or deceit in connection with securities transactions. Consistent with this objective, Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b5 issued under that Section are broad remedial provisions aimed at reaching misleading or deceptive activities, whether or not they are precisely and technically sufficient to sustain a common law action for fraud and deceit."
>
> "An affirmative duty to disclose material information has been traditionally imposed on corporate 'insiders', particularly officers, directors, or controlling

> stockholders. We and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to make disclosure in these circumstances constitutes violation of the anti-fraud provisions."

To the same effect is an earlier opinion, *In the Matter of Ward La France,* 13 SEC 373, 380, 381 (1943).

The Decision Below Is Contrary to the Intent of Congress

Congress, in the enactment of the Securities Act of 1933, the Securities Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, and the Investment Advisers Act of 1940, had as a fundamental purpose, common to these statutes, the substitution of a philosophy of full disclosure for the philosophy of *caveat emptor* so as to achieve a high standard of business ethics in the Securities industry (H. R. Rep. No. 85, 73rd Cong. 1st Sess.). See also Shulman, Civil Liability and the Securities Act, 43 Yale L. J. 227.

As this Court said in *J. I. Case Co.* v. *Borak,* 377 U. S. 426 (1964):

> "It is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose."

Congress has only recently reaffirmed the importance it placed on disclosure. Thus, in the Report of Special Study of Securities Markets of the Securities and Exchange Commission, H. R. Doc. No. 95, 88th Cong., 1st Sess, (1963) it was said "The keystone of the entire structure of Federal securities legislature is disclosure."

See also Loss, "Securities Regulation" at pages 1438, 1439, 1452, 1456, 1702.

The Decision Below Is Contrary to the Views of Commentators on the Subject

In Fleischer, *Federal Corporation Law: An Assessment,* 78 Harv. L. R. 1146, it is said:

> "* * * It would seem clear that the securities laws should not be given restrictive readings, and that Congress desired the federal anti-fraud provisions, for example, to be free of the ancient and illogical distinctions that at the time haunted state fraud law. And so the courts have read the congressional intent. In early decisions involving the securities laws the Supreme Court spoke of the need to interpret such remedial legislation in a fashion not to frustrate its purposes. That this congenial view has continued to the present appears from the *Capital Gains* and *Borak* decisions."

Similar views were expressed in an article by Knauss, *A Reappraisal of the Rule of Disclosures,* 62 Mich. Law Review, 607, 614 (1964).

> "The underlying theory is essentially that, given adequate information, the law of supply and demand, combined with action by each purchaser for his own best interest, will establish a true market value for a security."

In a review in 78 Harv. Law Rev. of the decisions of the Supreme Court, 1963 Term, it is said in the section dealing with decisions of the Court in the field of Securities Regulations:

> "Sections 10(b) and 15(c)(1) of the Securities Exchange Act, which proscribe fraud without mention-

ing omissions, have been implemented by Commission rules, enforced by the courts, which do prohibit omissions of material facts." (p. 295)

The Decision Below Conflicts With Other Holdings of the Second Circuit Itself

The Second Circuit in its decision in 1961 in *N Sims. Organ Co.* v. *The Securities and Exchange Commission,* 293 Fed. 2d 78, had held that reliance was not an element in the violation of the 1934 Act involved in that case. Moreover, in *Charles Hughes & Co.* v. *Securities & Exchange Comm'n,* 139 F. 2d 434, cert. denied, 321 U. S. 786 nondisclosure was treated by the Second Circuit as one variety of fraud or deceit.

May, 1965.

Respectfully submitted,

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INDEX

	Page
Statement	1
Discussion	4
Appendix	11

CITATIONS

Cases:

Cody, Roberts & Co., 40 S.E.C. 907 — 8

J. I. Case Co. v. *Borak*, 377 U.S. 426 — 5

Speed v. *Transamerica Corporation*, 99 F. Supp. 808, affirmed, 235 F. 2d 369 — 6

Statute and rule:

Securities Exchange Act of 1934, 48 Stat. 881, 15 U.S.C. 78a, *et seq.*:

Section 10(b), 15 U.S.C. 78j(b) — 1, 4, 5, 7, 11

S.E.C. Rules and Regulations under the Securities Exchange Act of 1934, 17 CFR 240.0–1, *et seq.*:

Rule 10b–5, 17 CFR 240.10b–5 — 1, 4, 5, 6, 7, 11

Miscellaneous:

Fleischer, *"Federal Corporation Law": An Assessment*, 78 Harv. L. Rev. 1146 (1965) — 5

Prosser, *Handbook of the Law of Torts* (2d Ed.) — 7

784-100—65

In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 66

ALBERT A. LIST, PETITIONER

v.

LOUIS C. LIEBLER, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE UNITED STATES AS AMICUS CURIAE

This memorandum is submitted pursuant to the Court's order of May 17, 1965, inviting the Solicitor General to express the views of the United States in the above case.

STATEMENT

Petitioner, a former stockholder of Fashion Park, Inc. ("Fashion Park"), brought suit for $160,293 in damages which he claimed to have suffered by reason of respondents' alleged violation of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder in connection with their purchase of petitioner's stock.[1] Following a trial without a jury the

[1] Section 10(b) and Rule 10b-5 are set forth in the Appendix, *infra*.